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In the Supreme Court of the United States

OCTOBER TERM, 1945

No. 263

A. L. LUSTHAUS, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE THIRD CIRCUIT

BRIEF FOR THE RESPONDENT

OPINIONS BELOW

The findings of facts and opinion of the Tax Court (R. 62–66) are reported at 3 T. C. 540. The opinion of the Circuit Court of Appeals (R. 68–71) and the dissenting opinion (R. 71–78) are reported at 149 F. 2d 232.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on April 11, 1945 (R. 79) and a petition for rehearing was denied on May 28, 1945 (R. 86). The petition for a writ of certiorari was filed on July 26, 1945, and granted on October

8, 1945. (R. 87). The jurisdiction of this Court was invoked under Section 240 (a) of the Judicial Code as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the court below erred in sustaining the decision of the Tax Court that the income attributed to petitioner's wife under a so-called partnership agreement was includible in his gross income as defined by Section 22 (a) of the Internal Revenue Code.

STATUTES AND REGULATIONS INVOLVED

The pertinent provisions of the statute and Regulations are set forth in the Appendix, *infra*, p. 30.

STATEMENT

The Tax Court found the following facts (R. 62–64):

For several years prior to 1940, the petitioner had operated as sole proprietor a retail furniture business at two stores in Uniontown, Pennsylvania, known, respectively, as the Household Furniture Company and the Furniture Outlet Store. (R. 62.)

During 1939, the petitioner had several conferences with an accountant and an attorney about bringing his wife into his furniture business as a partner. In the latter part of 1939 it was decided that he would "sell" to her a half interest in the business and make her an equal partner as of January 1, 1940. The petitioner instructed the

accountant to determine the value of the business and make the necessary changes in the books of accounts. He also instructed the attorney to prepare the necessary legal papers. (R. 63.)

The net value of the business, based on book value of all physical assets and inventory, but excluding good will, was determined to be approximately $230,000. It was decided that the petitioner would withdraw $20,000 from the business, leaving a net worth of approximately $210,000; that he would make his wife a gift of $50,000 to be used in part payment for a half interest in the business; and that she would give the petitioner her promissory notes in the amount of the balance, $55,000, payable $5,000 annually. The petitioner told his wife of the plan and she agreed to it. (R. 63.)

The formalities of the transfer were delayed, first by the illness of the petitioner's attorney in December of 1939, then by his absence in January and February of 1940, and finally by the absence of the petitioner and his wife in March and April of 1940. (R. 63.)

On June 4, 1940, the petitioner executed a bill of sale covering an undivided half interest in his furniture business for a stated consideration of $105,253.81, one-half of the estimated value of the business on December 31, 1939. On the same day the petitioner's wife executed a partnership agreement, and a few days later the petitioner borrowed $25,000 and gave her a check for $50,000.

This check was drawn against the funds which he had previously withdrawn from the business and also against those borrowed from the bank. The petitioner's wife then gave him her check dated June 18, 1940, for $50,253.81; and, as previously agreed upon, executed and delivered to him eleven promissory notes for $55,000, in payment of the balance of the purchase price for her interest in the partnership. At that time, she owned her home, valued at $25,000 or $30,000; and securities of $20,000 or $25,000. (R. 63.)

A certificate authorizing the petitioner and his wife to carry on business under the fictitious name of Household Furniture Company was issued by the Commonwealth of Pennsylvania on July 31, 1940. The petitioner filed a gift tax return for 1940 in which he reported a gift to his wife of $50,000 on January 1, 1940. (R. 63–64.)

The petitioner's furniture business was conducted in substantially the same manner after the consummation of the partnership arrangements as before. He continued to manage the business, as he was authorized to do by the partnership agreement. His wife helped out at the stores—or one of them—whenever she was needed, just as she had always done. She took no active part in the management of the business, and never received any compensation for her services. (R. 64.)

Prior to 1940, the petitioner and his wife had maintained a joint bank account. Some time in

1940 they opened separate accounts. A separate account was maintained for the business in the name of the Household Furniture Company. During 1940, the tax year involved, the wife withdrew $59.61 from the business, and the petitioner withdrew $4,604.76. The corresponding figures for the following year are $16,317.86 and $19,198.69. The petitioner's wife paid three of the eleven promissory notes executed under the partnership agreement as they became due. At the close of each year, the profits of the business were credited on the books to the petitioner and his wife equally. (R. 64.)

A partnership return filed in the name of the Household Furniture Company showed a net profit of $80,280.20 in 1940. The petitioner and his wife each reported one-half of that amount (less partnership contributions of $1,135.99) in their individual returns for 1940. (R. 64.)

The Tax Court sustained the determination by the Commissioner that the petitioner and his wife were not partners for purposes of the federal income tax, and that the petitioner was liable for tax on all of the profits from the furniture business for that year, which, with adjustments made in the deficiency notice and not put in controversy, amounted to $84,443.42. (R. 64–66.) The Circuit Court of Appeals affirmed the decision of the Tax Court. (R. 68–71, 79.)

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SUMMARY OF ARGUMENT

The Tax Court committed no error of law in deciding that income ascribed to the petitioner's wife by the partnership agreement was includible in his gross income for purposes of Section 22 (a) of the Internal Revenue Code.

The effectiveness for tax purposes of family partnership arrangements like that here involved must be tested by the fundamental principles that taxation is concerned with economic realities and not with refinements of legal title; that an anticipatory assignment of income, however, skillfully devised, is ineffective to relieve the donor of tax liability (*Lucas* v. *Earl,* 281 U. S. 111; *Helvering* v. *Horst,* 311 U. S. 112; *Helvering* v. *Eubank,* 311 U. S. 122); and that a legally perfect gift of income-producing property will not relieve the donor of tax on future income unless it operates to deprive him of such measure of the economic benefits of ownership, direct and indirect, that he may no longer be said to be the substantial owner of the property (*Helvering* v. *Clifford* 309 U. S. 331). The Tax Court correctly applied these principles, and its decision that the share of profits ascribed to the petitioner's wife by the partnership agreement was to be attributed to the respondent for tax purposes is entitled to finality since it had a rational basis in the evidence.

The Tax Court did not err in deciding that the petitioner's wife was not a partner with him for any relevant purpose, since it clearly appeared that she had made no substantial contribution of services or capital to the purported partnership. This decision is confirmed by other circumstances. The petitioner retained complete powers of management of the business, and power to deny his wife any distribution of its profits. He received no salary for his services, although they contributed in large measure to the income in question; and the wife was credited with a half interest in the profits, although her services were relatively unimportant.

On these facts, and in the absence of any effort by the petitioner to prove what portion, if any, of the income ascribed to the wife was actually derived from her insubstantial contributions to the business, the Tax Court committed no error in sustaining the Commissioner's determination that the income in dispute was includible in the petitioner's gross income.

ARGUMENT

THE TAX COURT COMMITTED NO ERROR OF LAW IN DECIDING THAT THE INCOME IN DISPUTE WAS INCLUDIBLE IN THE PETITIONER'S GROSS INCOME AS DEFINED BY SECTION 22 (a) OF THE INTERNAL REVENUE CODE, ALTHOUGH THAT INCOME WAS ASCRIBED TO HIS WIFE BY A PARTNERSHIP AGREEMENT

Like the respondent in *Commissioner* v. *Tower*, No. 317, October Term, 1945, the petitioner in this

case contends that the Commissioner and the Tax Court were bound as a matter of law to exclude from his gross income as defined by Section 22 (a) of the Internal Revenue Code (Appendix, *infra*) the share of business profits ascribed to his wife by the partnership agreement.

1. The family partnership form should be no more effective in deflecting income for tax purposes than are the forms of an irrevocable assignment, the family trust, or the wholly-owned corporation, which have often been denied effect for tax purposes by this Court. E. g., *Lucas* v. *Earl*, 281 U. S. 111; *Burnet* v. *Leininger*, 285 U. S. 136; *Douglas* v. *Willcuts*, 296 U. S. 1; *Helvering* v. *Clifford*, 309 U. S. 331; *Higgins* v. *Smith*, 308 U. S. 473. That the revenue laws contain special provisions with reference to partnerships of course affords no warrant for a contrary assertion. The revenue laws also contain special provisions for taxing trusts and corporations, yet numerous cases in this Court, including cases cited above, clearly establish that those forms do not prevent application of Section 22 (a).[1] See also, Paul, *Partnerships in Tax Avoidance*, 13 Geo. Wash. L. Rev. 121 (1945).

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[1] *Douglas* v. *Willcuts*, *supra*, involved the question whether the income of a trust was to be taxed to the grantor because of benefits which he enjoyed from payment of income to the beneficiary. This Court held in the affirmative, and in the course of its opinion said (296 U. S., pp. 9–10):

> We do not regard the provisions of the statutes as to the taxation of trusts, fiduciaries, and beneficiaries

In defining gross income in Section 22 (a), Congress exercised to the fullest extent its constitutional power to tax income. *Irwin* v. *Gavit*, 268 U. S. 161, 166; *Douglas* v. *Willcuts*, 296 U. S. at 9; *Helvering* v. *Clifford*, 309 U. S. at 334. The broad reach of that power, both in relation to what is income and who is to be taxed, is apparent from numerous decisions of this Court. An assignment of income to be earned or to accrue in the future, even though authorized by state law and irrevocable in character, is ineffective to render the income immune from taxation as that of the assignor. *Commissioner* v. *Harmon*, 323 U. S. 44, 46; *Lucas* v. *Earl*, *supra*; *Helvering* v. *Horst*, 311 U. S. 112; *Helvering* v. *Eubank*, 311 U. S. 122; *Burnet* v. *Leininger*, *supra*. "The power to dispose of income is the equivalent of ownership of it" (*Helvering* v. *Horst*, 311 U. S. at 118); and a transaction will not insulate the taxpayer from liability for the tax on income derived from property unless it deprives him of

(Revenue Acts, 1926, § 219; 1928, § 161, 162), as intended to apply to cases where the income of the trust would otherwise remain, by virtue of the nature and purpose of the trust, attributable to the creator of the trust and accordingly taxable to him. These provisions have appropriate reference to cases where the income of the trust is no longer to be regarded as that of the settlor, and we find no warrant for a construction which would preclude the laying of the tax against the one who through the discharge of his obligation enjoys the benefit of the income as though he had personally received it.

the attributes of substantial ownership as that term is employed in the federal law to designate retained control or other enjoyment of economic benefits (*Helvering* v. *Clifford, supra*; *Helvering* v. *Fuller,* 310 U. S. 69, 76, fn. p. 72; *Harrison* v. *Schaffner,* 312 U. S. 579; cf. *Burnet* v. *Wells,* 289 U. S. 670). Section 22 (a) is "not so much concerned with the refinements of title as with the actual command over the income which is taxed and the actual benefit for which the tax is paid". *Harrison* v. *Schaffner,* 312 U. S. at 581; *Corliss* v. *Bowers,* 281 U. S. 376, 378. Accordingly, mere passage of title to income-producing property through devices which are valid under state law does not require that future income from the property be excluded from the grantor's gross income under Section 22 (a), particularly where family arrangements are involved (*Helvering* v. *Clifford, supra*; *Helvering* v. *Horst, supra*); the taxpayer may remain liable for tax on income even though title to the property from which it has been derived or to the income itself has "vested" in another under state law (*Lucas* v. *Earl, supra*; *Helvering* v. *Eubank, supra*; *Commissioner* v. *Harmon, supra; Commissioner* v. *Court Holding Co.,* 324 U. S. 331); and corporations validly organized under state law may be ignored where they would serve merely to shift tax liability (*Gregory* v. *Helvering,* 293 U. S. 465; *Griffiths* v. *Commissioner,* 308 U. S. 355; *Higgins* v. *Smith,* 308 U. S. 473).

In sum, the decisions of this Court demonstrate that taxation is an intensely practical process which operates on the substance of transactions, whatever may be their form, and that retained command over income or its source or other enjoyment of economic benefits marks the real owner for income tax purposes. See also, *Commissioner* v. *Smith*, 324 U. S. 177, rehearing denied, 324 U. S. 695; *United States* v. *Joliet & Chicago R. Co.*, 315 U. S. 44; *Weiss* v. *Stearn*, 265 U. S. 242; *United States* v. *Phellis*, 257 U. S. 156; *Gulf Oil Corp.* v. *Lewellyn*, 248 U. S. 71; *Southern Pacific Co.* v. *Lowe*, 247 U. S. 330. And where, as in the present case, an intra-family transaction is involved, "special scrutiny of the arrangement is necessary lest what is in reality but one economic unit be multiplied into two or more by devices which, though valid under state law, are not conclusive so far as § 22 (a) is concerned". *Helvering* v. *Clifford*, 309 U. S. at 335.

2. Family partnership cases follow in a sense *a fortiori* from the trust and corporation cases cited above, since, unlike trusts and corporations, partnerships are not accorded the status of separate taxable entities. Paul, *Partnership in Tax Avoidance*, *supra*, p. 122; cf. *Neuberger* v. *Commissioner*, 311 U. S. 83. In general, partnerships are recognized only for information purposes. *Rossmoore* v. *Commissioner*, 76 F. 2d 520, 521 (C. C. A. 2d). Section 181 of the Internal Revenue Code (Appendix, *infra*), provides that indi-

viduals carrying on business in partnership shall be liable for income tax only in their individual capacity. Individual liability is imposed by Section 11 (Appendix, *infra*); and Section 182 (Appendix, *infra*) prevents the existence of a partnership from altering the normal incidence of the tax, by providing that the partners shall include in their net income their distributive shares of partnership income, whether or not distribution is actually made. Cf. *Heiner* v. *Mellon*, 304 U. S. 271; *Earle* v. *Commissioner*, 38 F. 2d 965 (C. C. A. 1st).[2]

We acknowledge that the Commissioner is bound to accept the agreed division of the profits for purposes of applying Section 22 (a) to measure the individual liability of each partner, where a partnership has been truly organized for business purposes and is employed by the parties for the carrying on of business in partnership within the meaning of Section 181. But under the principles discussed above, the Commissioner is not required to recognize every family partnership agreement or to give tax effect to the agreed divi-

[2] See also Sections 183–188 with respect to partnership income.

In addition to these provisions, the Internal Revenue Code sets forth, in Section 3797 (a) (2) (Appendix, *infra*), a general definition of partnerships. While this definition does not affect the present case, it is to be noted that it is applied with reference to exclusively federal concepts. E. g., *Burk-Waggoner Assn.* v. *Hopkins*, 269 U. S. 110; *Morrissey* v. *Commissioner*, 296 U. S. 344.

sion of profits therein. In accordance with those principles, the Circuit Courts of Appeals and the Tax Court have repeatedly held in an impressive number of cases that he need not do so where the purported partnership amounts to nothing more than a reallocation of income within the family.[3]

[3] *Doll* v. *Commissioner*, 149 F. 2d 239 (C. C. A. 8th), certiorari denied October 8, 1945; *Lorenz* v. *Commissioner*, 3 T. C. 746, affirmed *per curiam*, 148 F. 2d 527 (C. C. A. 6th), petition for rehearing denied October 15, 1945; *Cohan* v. *Commissioner*, 39 F. 2d 540 (C. C. A. 2d); *Fisher* v. *Commissioner*, 29 B. T. A. 1041, affirmed *per curiam*, 74 F. 2d 1014 (C. C. A. 2d); *Eaton* v. *Commissioner*, 37 B. T. A. 283, affirmed *per curiam*, 100 F. 2d 1013 (C. C. A. 2d), certiorari denied, 307 U. S. 636; *Cobington* v. *Commissioner*, 103 F. 2d 201 (C. C. A. 5th); *Tinkoff* v. *Commissioner*, 120 F. 2d 564 (C. C. A. 7th), certiorari denied, 314 U. S. 581; *Earp* v. *Jones*, 131 F. 2d 292 (C. C. A. 10th), certiorari denied, 318 U. S. 764; *Mead* v. *Commissioner*, 131 F. 2d 323 (C. C. A. 5th), certiorari denied, 318 U. S. 777; *Waldburger* v. *Helvering*, 131 F. 2d 598 (C. C. A. 2d); *Villere* v. *Commissioner*, 133 F. 2d 905 (C. C. A. 5th); *Schroder* v. *Commissioner*, 134 F. 2d 346 (C. C. A. 5th); *Argo* v. *Commissioner*, 150 F. 2d 67 (C. C. A. 5th), certiorari denied November 5, 1945; *Supornick* v. *Commissioner*, 150 F. 2d 110 (C. C. A. 8th); *Miller* v. *Commissioner*, 150 F. 2d 823 (C. C. A. 2d); *Grant* v. *Commissioner*, 150 F. 2d 915 (C. C. A. 10th); *Bradshaw* v. *Commissioner*, 150 F. 2d 918 (C. C. A. 10th); *Estate of Sewell* v. *Commissioner* (C. C. A. 5th), decided November 9, 1945, not yet reported; *Buchanan* v. *Commissioner*, 20 B. T. A. 210; *Robertson* v. *Commissioner*, 20 B. T. A. 112; *McIntyre* v. *Commissioner*, 37 B. T. A. 812; *Lowry* v. *Commissioner*, 3 T. C. 730, pending on review by the United States Circuit Court of Appeals for the Sixth Circuit; *Hash* v. *Commissioner*, 4 T. C. 878, pending on petition for review by the United States Circuit Court of Appeals for the Fourth Circuit; *McEachern* v. *Commissioner*, 5 T. C. 23; *Munter* v. *Commissioner*, 5 T. C. 39; *Thorrez* v. *Commissioner*, 5

Family partnership arrangements predicated upon technical transfers of capital are not immune from the operation of the basic principles discussed at the outset of this brief. It is accordingly well settled that although the transfer and the partnership agreement are valid under state law, the arrangement is without federal income tax significance if in substance and practical effect it amounts primarily to an attempted reallocation of the transferor-taxpayer's business income. It should be immaterial in this connection whether the business income sought to be reallocated is derived from the taxpayer's personal services, from capital transferred by him to a "partner" and reinvested in the business, or from a combination of both sources. Since it is elementary that income from personal services is taxable to him who earns it (*Lucas* v. *Earl, supra; Helvering* v. *Eubank, supra; Burnet* v. *Leininger, supra*), the business income derived from the transferor-taxpayer's services remains taxable to him despite the partnership arrangement (*Doll* v. *Commissioner,* 149 F. 2d 239 (C. C. A. 8th), certiorari denied October 8, 1945; *Tinkoff* v. *Commissioner,* 120 F. 2d 564 (C. C. A. 7th), certiorari denied, 314 U. S. 581; *Schroder* v. *Commissioner,* 134 F.

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2d 346 (C. C. A. 5th); *Villere* v. *Commissioner*, 133 F. 2d 905 (C. C. A. 5th); *Cohan* v. *Commissioner*, 39 F. 2d 540 (C. C. A. 2d); *Fisher* v. *Commissioner*, 29 B. T. A. 1041, affirmed *per curiam*, 74 F. 2d 1014 (C. C. A. 2d)). And since it is equally fundamental that income from property is taxable to him who commands the economic benefits of ownership (*Helvering* v. *Clifford, supra*; cf. *Harrison* v. *Schaffner, supra*), the business income attributable to capital likewise remains taxable to the transferor-taxpayer if the transfer of capital and the accompanying partnership arrangement do not serve to deprive him of the control of the capital or of substantial enjoyment of the profits produced by it (*Lorenz* v. *Commissioner*, 3 T. C. 746, affirmed *per curiam*, 148 F. 2d 527 (C. C. A. 6th), petition for rehearing denied October 15, 1945; *Earp* v. *Jones*, 131 F. 2d 292 (C. C. A. 10th), certiorari denied, 318 U. S. 764; *Mead* v. *Commissioner*, 131 F. 2d 323 (C. C. A. 5th), certiorari denied, 318 U. S. 777; *Supornick* v. *Commissioner*, 150 F. 2d 110 (C. C. A. 8th); *Miller* v. *Commissioner*, 150 F. 2d 823 (C. C. A. 2d); *Losh* v. *Commissioner*, 145 F. 2d 456 (C. C. A. 10th); *Bradshaw* v. *Commissioner*, 150 F. 2d 918 (C. C. A. 10th); *Grant* v. *Commissioner*, 150 F. 2d 915 (C. C. A. 10th); *Argo* v. *Commissioner*, 150 F. 2d 67 (C. C. A. 5th), certiorari denied November 5, 1945; *Estate of Sewell* v. *Commissioner* (C. C.

A. 5th), decided November 9, 1945, not yet reported).[4]

3. In applying the foregoing principles, the question whether a particular family partnership arrangement works such a substantial change in the transferor-taxpayer's control of the business or enjoyment of the profits as to insulate him from liability for the tax on income, normally presents an issue of ultimate fact, and has been so treated. *Doll* v. *Commissioner*, 149 F. 2d at 244, 247; *Argo* v. *Commissioner*, 150 F. 2d at 68; *Lorenz* v. *Commissioner*, *supra*; *Miller* v. *Commissioner*, 150 F. 2d at 824; *Supornick* v. *Commissioner*, 150 F. 2d at 111; *Grant* v. *Commissioner*, 150 F. 2d at 917; *Bradshaw* v.

[4] Under like reasoning we think that in an appropriate case the Commissioner might determine that, even though the wife actually made more than a nominal contribution to the partnership capital, the partnership arrangement is effective only in part or that the allocation of earnings to her exceeds that which her capital has produced for her, and to the extent that it does is a mere allocation of family income. If the arrangement for sharing the profits with the wife reflects not only her contribution but also an assignment to her of future earnings from the husband's services or capital, such an assignment is ineffective for purposes of Section 22 (a), "however skillfully devised" (*Lucas* v. *Earl*, *supra*, p. 115; *Harrison* v. *Shaffner*, *supra*, p. 582), and of course may not be effective by being commingled with another transaction which itself is effective. The Commissioner may separate the constituent elements and deal with them accordingly. Cf. *German* v. *Commissioner*, 2 T. C. 474; 483–484; *Mauldin* v. *Commissioner*, 5 T. C. No. 91, pp. 5–6; Mellott, J., concurring in *Thorrez* v. *Commissioner*, 5 T. C. 60, 72; *McEachern* v. *Commissioner*, 5 T. C. 23, 31.

Commissioner, 150 F. 2d at 920; *Estate of Sewell* v. *Commissioner, supra; Mead* v. *Commissioner,* 131 F. 2d at 324; *Waldburger* v. *Helvering,* 131 F. 2d 598. As this Court observed in the similar *Clifford* case, 309 U. S. at 336, "no one fact is normally decisive." Since it is the function of the Tax Court to weigh the evidence, find the facts, and choose between possible inferences, its decision is entitled to finality if it has applied the correct principles. *Commissioner* v. *Court Holding Co., supra; Commissioner* v. *Scottish American Co.,* 323 U. S. 119; *Dobson* v. *Commissioner,* 320 U. S. 489, rehearing denied, 321 U. S. 231; *Wilmington Co.* v. *Helvering,* 316 U. S. 164.

While we think that some decisions of the Tax Court in the family partnership cases apparently have rested on erroneous views of the law as established by previous decisions of this Court, it is clear that those views are now held only by a minority of the Tax Court. Compare, for example, its latest decisions in *McEachern* v. *Commissioner,* 5 T. C. 23; *Munter* v. *Commissioner,* 5 T. C. 39; *Thorrez* v. *Commissioner,* 5 T. C. 60; *De Korse* v. *Commissioner,* 5 T. C. 94; *Fox* v. *Commissioner,* 5 T. C. 242; *Singletary* v. *Commissioner,* 5 T. C. 365; *Greenberg* v. *Commissioner,* 5 T. C. No. 90; and *Mauldin* v. *Commissioner,* 5 T. C. No. 91, with its somewhat earlier decisions in *Scherer* v. *Commissioner,* 3 T. C. 776, *Johnston* v. *Commissioner,* 3 T. C. 799; and *Smith* v. *Commissioner,* 3

T. C. 894. The later decisions manifest consistent adherence by a majority of the Tax Court to the correct principles of law. In the present case the Tax Court applied the correct principles of law, and its decision has abundant support in the record.

4. With a lack of any apparent purpose for the organization of a partnership other than the obvious purpose of reducing taxes on the profits of his business, the taxpayer at first considered giving his wife a half interest in the business. (R. 39, 65.) He finally decided against that plan in favor of the one outlined below.

After consulting with his accountant and attorney, the petitioner decided to make a "gift" to his wife of $50,000[5] to enable her to become a partner with him by payment of a substantial part of the purchase price of a half interest in his business. (R. 63.) The balance of the purchase price was to be represented by notes of the wife in the total amount of $55,000, payable $5,000 annually, and it was anticipated that these

[5] This sum was apparently fixed with reference to the specific exemption of $40,000 from gift tax, provided by Section 1004 (a)-1 of the Internal Revenue Code, and to the exclusion provided by Section 1003 (b) thereof. (R. 13, 46.) Although the record does not disclose how much tax was paid with respect to the gift, it is doubtful whether the tax was more than a comparatively negligible amount. Compare the situation in *Commissioner* v. *Tower*, No. 317, where the gift was valued at $57,114.60, and the gift tax amounted to $213.44. (See record, No. 317, p. 12.)

payments would be met from her agreed share of the profits of the business. (R. 15, 63.) The wife had very little to do with these arrangements or the formal agreement that followed, but did what she was told to do. (R. 28–29, 65.)

While this plan was decided upon in the latter part of 1939, the formalities of execution did not take place until nearly half the tax year involved, 1940, had elapsed. On the fourth of June, 1940, the petitioner executed a bill of sale of an undivided half interest in his business for the stated consideration of $105,253.81, and the wife executed a partnership agreement. (R. 63.) A few days later the petitioner borrowed $25,000 from a bank and gave the wife his check for $50,000, drawn against this amount, and against a further amount of $20,000 which he had withdrawn from the business in pursuance of the plan. The wife then gave him her check for $50,253.81, and the petitioner thereupon repaid the $25,000 to the bank. (R. 14, 63.) The wife also gave the petitioner eleven notes in the amount of $5,000 each, payable serially on the first day of 1941 and each following year until payment of the last of the series. (R. 56, 63.) The wife thus contributed from her own funds only $253.81, the amount of the difference between the "gift" of $50,000 and her return payment.

The notes payable over a period of eleven years did not represent any substantial contribution to the capital of the partnership. The notes were

not discounted, and it was understood that they were to be paid from the profits ascribed to the wife by the partnership agreement. (R. 15, 65.) And while the agreement provided that she should share partnership losses equally with the petitioner, her liability was of no practical significance, since in the petitioner's own view the business was worth more than $210,000, exclusive of good will; and during the tax year it had profits in excess of $80,000. The business was not a hazardous one. Its inventory was less than $40,000 at the beginning of the tax year, and slightly more than $50,000 at the end. (R. 57–58.)

In short, then, the business needed no additional capital, and by the partnership arrangement got none except the insubstantial amount of $253.81 contributed by the wife from her own funds.

Nor did the wife make any substantial additional contribution of services to the business. While it appears that she "helped out at the stores * * * whenever she was needed just as she had always done", she took no part in the management of the business, and had received no compensation for similar services before the execution of the partnership agreement. (R. 64.)

Further circumstances bear out the decision of the Tax Court that there was no partnership for purposes of Section 181, and that the petitioner had failed to establish that the Commissioner erred in determining that the entire income of the

business was includible in the petitioner's gross income under Section 22 (a).

Under the partnership agreement, the petitioner retained full control in all matters pertaining to the operation and management of the business, and his decision in these matters was to be final. (R. 49–50.) While the income of the business was derived largely from his personal services and ability as manager, no provision was made for payment of any salary to him, and it was provided that the profits of the business should be credited equally to himself and his wife. (R. 49.) Withdrawals were to be made only upon agreement of both that they would not be detrimental to the welfare or expansion of the business. (R. 50.) The agreement provided, moreover, that "under no circumstances" should either the petitioner or the wife sell or assign the interest ascribed by the partnership agreement, without the written consent of the other. (R. 50.)

The unreality of the arrangement as a business partnership is emphasized by the manner in which it was availed of during the tax year. The business was conducted in substantially the same manner under the partnership form as when the petitioner was admittedly the sole proprietor. (R. 64.) Although his personal services were largely responsible for its success, he was allowed no salary, and the wife was credited with profits of the business on an equal footing with him. (R. 64, 66.) On the other hand, she withdrew

but $59.61 of the more than $84,000 of the profits of the business during 1940, the tax year.[6] (R. 64.) During the tax year, and until 1943, the bank with which the business dealt was not authorized to accept the wife as a partner with power to draw checks; and the petitioner continued to file social security tax returns as owner of the business throughout the tax year. (R. 16–19, 70.)

It is apparent, then, that the wife was a partner in name and on paper only. For a capital contribution of little more than $200, made in the middle of the tax year, and for services which had previously been deemed of so little consequence as to merit no payment of compensation, the wife was credited with profits of the business in excess of $40,000, yet withdrew less than $60. And on the record it is inconceivable that the petitioner could have considered himself any the poorer after the making of the partnership arrangement. Cf. *Helvering* v. *Clifford,* 309 U. S. at 335–336. Plainly the Tax Court was not bound

[6] While the wife withdrew substantial amounts after the tax year involved, the withdrawals apparently were made principally to make payments on the notes executed to cover the purchase price. (R. 9.) In the absence of evidence to the contrary, it may not be assumed that any withdrawals in excess of amounts needed for that purpose were not used to satisfy the petitioner's legal or moral family obligations. Cf. *Helvering* v. *Clifford*, 309 U. S. at 335. And in any event, an arrangement for deflecting income may not be validated by events subsequent to the tax year in question. Cf. *Argo* v. *Commissioner, supra.*

as matter of law to accord tax consequences to this transparent device.

To permit the technical considerations relied on by the petitioner to prevail in this case would "exalt artifice above reality" (*Gregory* v. *Helvering*, 293 U. S. at 470), give effect to the very type of formalism which this Court has consistently held ineffective (e. g., *Helvering* v. *Clifford*, 309 U. S. at 336–337; cf. *Commissioner* v. *Smith*, *supra*), and "permit the schemes of taxpayers to supersede legislation" (*Higgins* v. *Smith*, 308 U. S. at 477). See also, *Miller* v. *Commissioner*, *supra*.[7]

5. The petitioner's argument that he retained no more control than is sometimes conferred upon a manager or agent in business transactions is like the contention made in the *Clifford* case which sought to assimilate the donor's control with that of an ordinary fiduciary. But this Court firmly rejected that contention, saying (309 U. S. 335–336):

[7] In the *Miller* case the Circuit Court of Appeals said of a family partnership arrangement predicated upon a gift of capital (150 F. 2d at 824):

> * * * the completeness with which the forms were observed is of no significance, for it is precisely what we should expect, if they were to be only forms. * * * Unless we must allow ourselves to be fobbed off by an elaborate documentary paraphernalia, because it is completely carried out, it is impossible to upset the finding. Indeed, it shows a curious trust in the efficacy of the written word, that the appeal should have gone beyond the Tax Court.

> If it be said that such control is the type of dominion exercised by any trustee, the answer is simple. We have at best a temporary reallocation of income within an intimate family group. Since the income remains in the family and since the husband retains control over the investment, he has rather complete assurance that the trust will not effect any substantial change in his economic position. It is hard to imagine that respondent felt himself the poorer after this trust had been executed or, if he did, that it had any rational foundation in fact. For as a result of the terms of the trust and the intimacy of the familial relationship respondent retained the substance of full enjoyment of all the rights which previously he had in the property.

And the argument erroneously assumes that retention of control of principal is the only substantial attribute of ownership which might support an inference that the donor remains the substantial owner for purposes of Section 22 (a). It is plain from the opinion in the *Clifford* case (pp. 336–337) that while retention of control over *corpus* may sometimes be the "all-important factor" *per se*, "no one fact is normally decisive" and continued enjoyment of other economic benefits, direct or indirect (as was the case here), may also warrant that conclusion; it is the entire "bun-

dle of rights" retained by the donor that the trial court must consider.*

True, the agreement provided that the partnership was to last for a period of 15 years, and that upon "dissolution and liquidation * * * the assets of said partnership at the time of said dissolution or liquidation shall be divided or apportioned equally between the Partners according to their respective capital interests or investments in the partnership, as shown by the books of the partnership as of the date of dissolution." (R. 48–49). This provision appears to contemplate that the interest of the wife for purposes of liquidation might be quite different from that asserted for purposes of this case. Cf. *Grant* v. *Commissioner,* 150 F. 2d at 917. The wife's interest for purposes of this case appears to have been "more fanciful than real." *Earp* v. *Jones,* 131 F. 2d at 293. In the absence of a formal provision of this nature the arrangement might have lacked even the bare legal formal requisites; its presence, however, clearly did not preclude the Tax Court from concluding that for all practical purposes the peti-

* Since petitioner here continued to enjoy the income benefits, in addition to management control of the principal, the instant case is an even stronger one than the *Clifford* case for treating the donor as the substantial owner. In the *Clifford* case it was stipulated (p. 333) that all of the income was placed in the wife's personal checking account, that it was expended by her on herself and her children, and that the donor-husband used other funds to relieve himself of his duty to support.

tioner remained the owner of the business during the tax year. In the words of this Court in the *Clifford* case (309 U. S. 336–337):

> To hold otherwise would be to treat the wife as a complete stranger; to let mere formalism obscure the normal consequences of family solidarity; and to force concepts of ownership to be fashioned out of legal niceties which have little or no significance in such household arrangements.

The petitioner could no more deflect for purposes of Section 22 (a) the income from property of which he retained such substantial control than he could deflect income from his personal services; the same principles require that both be included in his gross income as defined by that section. E. g., *Helvering* v. *Clifford, supra*; *Commissioner* v. *Harmon, supra.* The petitioner has put misplaced reliance on *Blair* v. *Commissioner,* 300 U. S. 5, as sustaining his contention that the incidence of the federal income tax is controlled by state concepts of title. The opinion of this Court in that case expressly recognized that transfer of title to property under state law is not determinative of federal income tax liability where the transferor retains control or other means of economic enjoyment. See 300 U. S. at 12.

The principle that a gift of income from property of which the donor retains controls equivalent to substantial ownership is ineffective for

purposes of Section 22 (a) although it may be valid and effectively pass title for purposes of state law, of course applies with undiminished force where the partnership form is employed. *Grant* v. *Commissioner, supra*; *Bradshaw* v. *Commissioner, supra*; *Argo* v. *Commissioner, supra*; *Lorenz* v. *Commissioner, supra*; *Losh* v. *Commissioner,* 145 F. 2d 456 (C. C. A. 10th); *Miller* v. *Commissioner, supra*; *Mead* v. *Commissioner, supra*; *Schroder* v. *Commissioner, supra*; *Covington* v. *Commissioner, supra.* The petitioner's arguments with respect to the validity of the partnership, and of the effect of the transaction as passing title to his wife, are therefore inapposite.

The early opinions of the lower federal courts relied upon by the petitioner are not authoritative to the extent that they may be understood to sustain his position. Compare, e. g., *Rose* v. *Commissioner,* 65 F. 2d 616 (C. C. A. 6th), and *Bardach* v. *Commissioner,* 90 F. 2d 323 (C. C. A. 6th), with the later ruling by the same court in *Lorenz* v. *Commissioner, supra*;[9] and *Edson* v.

[9] Although it is true that the Sixth Circuit Court of Appeals ruled against the Government in the *Tower* case, No. 317, that decision was by a divided court, with Judge Martin dissenting; in the *Lorenz* case, decided 11 days later, where Judge Martin was joined by two other judges, the decision was unanimously for the Government. Thus, of the five judges who have recently considered this issue in the Sixth Circuit, only two have indicated views at variance with our position herein.

Lucas, 40 F. 2d 398 (C. C. A. 8th), with the decision by the same court in *Tyson* v. *Commissioner*, 146 F. 2d 50. The partnership arrangement was in substance merely an anticipatory assignment of business income which, like any other gift of income, is unavailing for purposes of Section 22 (a).[10] *Harrison* v. *Schaffner, supra*; *Helvering* v. *Horst, supra*; *Helvering* v. *Eubank, supra*; *Burnet* v. *Leininger, supra*; *Lucas* v. *Earl, supra*. In the *Schaffner* case, this Court held (312 U. S. at 582) that a donor could not escape tax on income from the corpus of a trust by "attempting to clothe the transaction in the guise of a transfer of trust property rather than the transfer of income, where that is its obvious purpose and effect". That a gift of income is irrevocable under state law is of course inconsequential for purposes of Section 22 (a). *Lucas* v. *Earl, supra*; *Commissioner* v. *Harmon, supra*.

Finally, it can avail the petitioner nothing to contend that the partnership arrangement was made in good faith, whatever that may mean. The Tax Court apparently considered that it was not. (R. 65.) While the lack of any apparent purpose other than tax avoidance constituted a

[10] The Tax Court properly ignored the wife's contributions of the insubstantial amount of $253.81, and of relatively unimportant personal services, since the petitioner made no effort to prove that any amount should be allocated to those sources. Cf. *Welch* v. *Helvering*, 290 U. S. 111; *Interstate Transit Lines* v. *Commissioner*, 319 U. S. 590. See also, footnote 4, *supra*.

cumulative factor sustaining the Tax Court's decision, there is no warrant whatever for the view that Section 22 (a) would have to yield to the taxpayer's good faith. It is well settled that tax consequences flow from the true nature of the transaction, irrespective of its motivation. *Gregory* v. *Helvering, supra; Higgins* v. *Smith, supra; Griffiths* v. *Commissioner, supra; Helvering* v. *Clifford, supra.*

CONCLUSION

The decision below is correct and should be affirmed.

Respectfully submitted.

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APPENDIX

Internal Revenue Code:

SEC. 11. NORMAL TAX ON INDIVIDUALS.

There shall be levied, collected, and paid for each taxable year upon the net income of every individual a * * * tax * * *. (26 U. S. C. 11.)

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service * * * of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * * (26 U. S. C. 22.).

SEC. 181. PARTNERSHIP NOT TAXABLE.

Individuals carrying on business in partnership shall be liable for income tax only in their individual capacity. (26 U. S. C. 181.)

SEC. 182. TAX OF PARTNERS.

In computing the net income of each partner, he shall include, whether or not distribution is made to him—

* * * * * *

(c) His distributive share of the ordinary net income or the ordinary net loss of

the partnership, computed as provided in section 183 (b). (26 U. S. C. 182.)

SEC. 183. COMPUTATION OF PARTNERSHIP INCOME.

(a) *General rule.*—The net income of the partnership shall be computed in the same manner and on the same basis as in the case of an individual except as provided in subsections (b) and (c). (26 U. S. C. 183.)

SEC. 188. DIFFERENT TAXABLE YEARS OF PARTNER AND PARTNERSHIP.

If the taxable year of a partner is different from that of the partnership, the inclusions with respect to the net income of the partnership, in computing the net income of the partner for his taxable year, shall be based upon the net income of the partnership for any taxable year of the partnership (whether beginning on, before, or after January 1, 1939) ending within or with the taxable year of the partner. (26 U. S. C. 188.)

SEC. 3797. DEFINITIONS.

(a) When used in this title, where not otherwise distinctly expressed or manifestly incompatible with the intent thereof—

* * * * * *

(2) *Partnership and Partner.*—The term "partnership" includes a syndicate, group, pool, joint venture, or other unincorporated organization, through or by means of which any business, financial operation, or venture is carried on, and which is not, within the meaning of this title, a trust or estate or a corporation; and the term "partner" includes a member

in such a syndicate, group, pool, joint venture, or organization.

* * * * *

(26 U. S. C. 3797.)

Treasury Regulations 103, promulgated under the Internal Revenue Code:

SEC. 19.22 (a)–1. *What included in gross income.*—Gross income includes in general compensation for personal and professional services, business income, profits from sales of and dealings in property, interest, rent, dividends, and gains, profits, and income derived from any source whatever, unless exempt from tax by law. (See sections 22 (b) and 116.) In general, income is the gain derived from capital, from labor, or from both combined, * * *.

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